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DIRECTORATE OF
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Intelligence Memorandum

The Current Japanese Economic Slowdown

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
December 1971

INTELLIGENCE MEMORANDUM

The Current Japanese Economic Slowdown

Introduction

1. Japan is currently experiencing an economic slowdown after five years of unparalleled growth. Persisting for more than a year, the slowdown has reduced economic growth from a whopping 12% average to about half that rate. The slower growth of domestic demand has reduced import growth markedly, while producers have pushed exports to maintain output. The resulting increased Japanese trade surplus with the United States contributed greatly to the mushrooming US balance-of-payments deficit, which resulted in suspension of the dollar's convertibility and imposition of the import surcharge on 15 August 1971. Many Japanese now blame the US measures for the failure of an expected summer economic recovery to materialize. This memorandum examines the causes of Japan's economic slowdown and assesses the economic outlook for 1972.

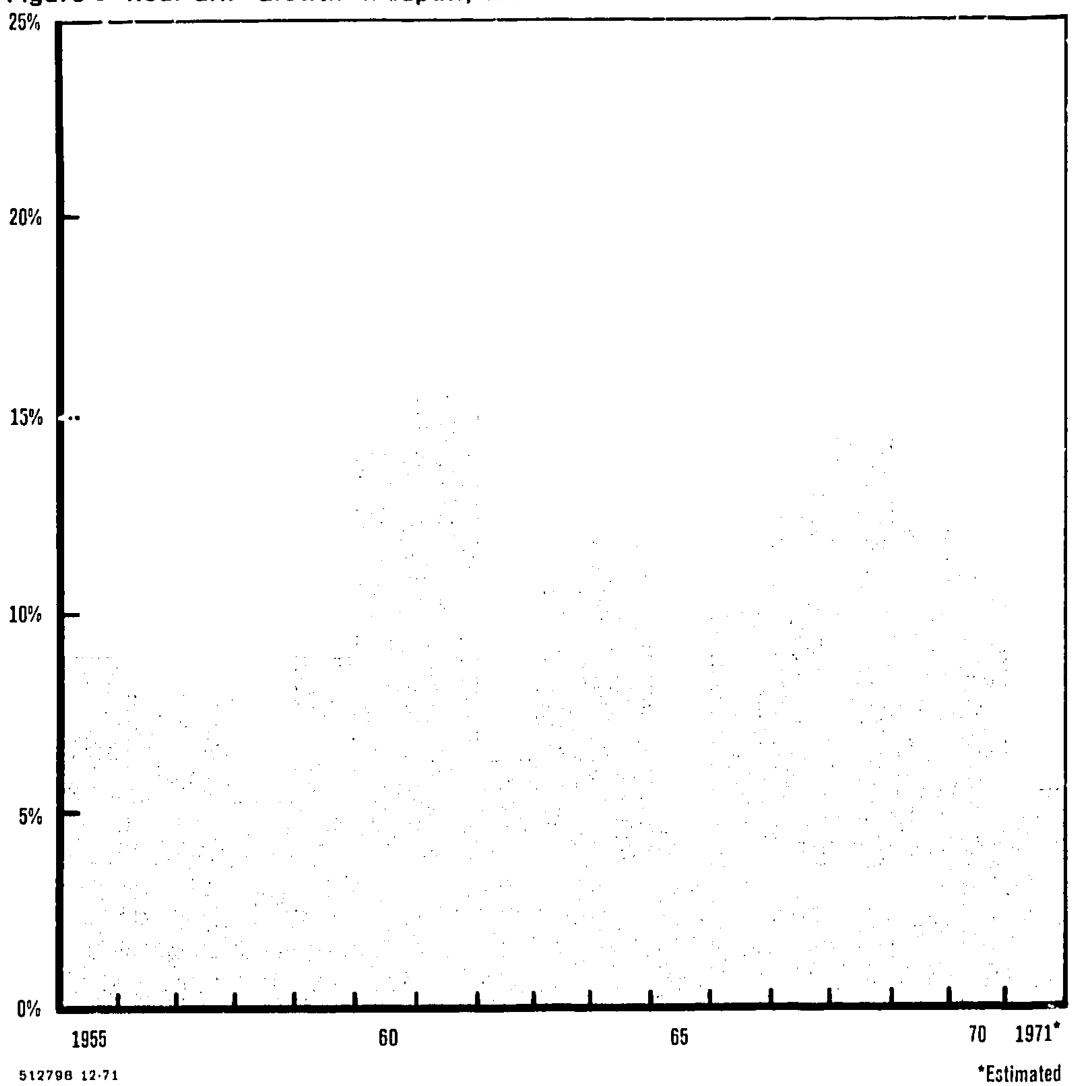
Background

2. Japan's extraordinary economic progress since 1955 has followed a pattern of rapid growth in two- to five-year spurts interrupted by a slowdown of a year or so. During the slowdowns the growth rate usually fell to about half of the annual average during the preceding boom period (see Figure 1). The factor mainly responsible for the downturns in 1958, 1962, and 1965 was monetary restraint prompted by balance of payments difficulties. In each case import growth exceeded export growth during the boom period, and Japan recorded a large balance-of-payments deficit. With only small foreign

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

exchange reserves available, Tokyo invoked restrictive monetary measures to cool down the economy. Over the long run, however, exports have been growing more rapidly than imports, and by the late 1960s this balance-of-payments constraint was no longer operative.

Figure 1. Real GNP Growth in Japan, 1955 to 1971 (Percent Increase)



3. The 1966-70 economic boom was postwar Japan's longest. With the transition to a balance-of-payments surplus and a high level of domestic and foreign demand for Japanese products, investor confidence in the country's economic future grew and investment rose to an extraordinarily high level. Gross investment increased an average of 22% annually during 1966-70 reaching 39% of gross national product during that period's last three years. This ratio compares

with about 25% for the European Community countries as a group and 18% for the United States. Moreover, relative to other industrial countries, especially the United States, an unprecedentely large share of Japanese investment was in plant and equipment. For example, 1970 private Japanese plant and equipment investment accounted for 21% of GNP compared with 10% in the United States. The high and growing proportion of GNP devoted to investment unquestionably was a major factor in the economy's rapid growth.

4. There were two relatively distinct stages in the economy's most recent boom. The first was 1966-68, when expansion occurred partly as the result of increased capacity utilization. This was possible because of the slowdown the year before, when production fell short of capacity. By the end of 1968, however, the slack was completely taken up, and investment in inventories and fixed capital began to increase more rapidly than GNP in anticipation of a sustained rapid growth in demand (see Figure 2). Although large gains in output continued in 1969-70, wage increases began to outpace productivity growth and, as wholesale and export prices began to rise, Tokyo became concerned about the economy overheating. Consequently, as early as September 1969 the Bank of Japan increased the discount rate, indicating a shift to restrictive monetary policies.

Causes of Japan's Economic Slowdown

5. Monetary restraint thus has been partly responsible for slowing down economic growth. High interest rates induced producers to restrict inventory buildup and probably played a role in the reassessment of planned fixed investment. But at the same time, more fundamental factors were affecting economic expansion. The extremely high investment rate had created some overcapacity by early 1970, and inventories of finished goods relative to GNP were becoming very high. Under these conditions the growth rate of both inventories and fixed investment tapered off. The government's policy of monetary restraint probably cut back investment growth further than desired. In any case, the rise in aggregate demand slackened appreciably. Producers' inventories grew as they tried to maintain full production, but firms soon were forced to cut back, compounding the depressing effect.

Figure 2a. Growth Rates of Gross Fixed Investment, Private Consumption, and Gross National Product
Quarterly 1965 to 1971

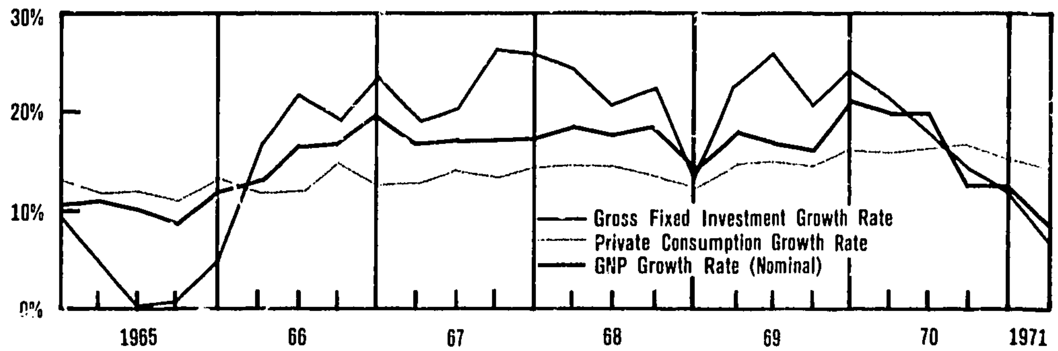
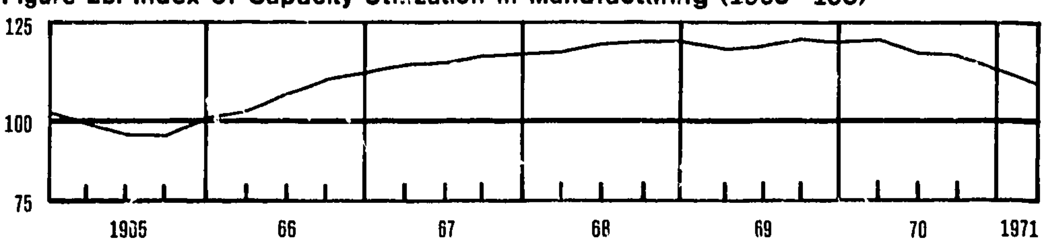


Figure 2b. Index of Capacity Utilization in Manufacturing (1965=100)



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6. Real GNP growth fell to about a 5% to 6% annual rate in the last quarter of 1970 and during most of 1971, compared with 12% annually during the previous boom. Hardest hit were the basic industries -- notably steel and aluminum -- and the capital goods producers. Steel output during the first nine months of 1971, for example, was some 6% below the same 1970 period.

7. The Japanese also have indicated that their economic slump has been due to lower than expected domestic demand for automobiles and television sets, but there is little justification for these assertions. Domestic autombile purchases have slowed since 1970, but this was widely expected as the market approached saturation. Moreover, the 80% increase in automobile exports in the first nine months of 1971, compared with the same period in 1970, largely offset the slowdown in domestic purchases. Japanese consumers did reduce their television purchases in late 1970, when the US Tariff Commission revealed that Japanese color television sets were being sold in the United States at much lower prices than in Japan. But the drop in sales was only temporary.

8. Altogether, private consumption demand has fared quite well throughout the economic slowdown. Underlying this trend was the fact that unemployment has remained at less than 1.5% of the work force. Moreover, wages increased by some 15% in nominal terms and 10% in real terms in 1971, or only slightly below the rapid pace of recent years.

25X6

10. Although confidence about future export growth may have been adversely affected recently, Japanese export performance has remained a bright spot in the economic picture. Exports during the first 11 months of 1971 were up some 25% over the corresponding 1970 period. Recent export growth thus has considerably exceeded the average 18% rate of 1965-70. Because weakening domestic demand has at the same time caused imports to stagnate, the trade surplus will nearly reach an extraordinary $8 billion in 1971 -- the largest recorded by any country in the past two decades. Japan's surplus with the United States alone probably will approximate $3.3 billion.

Government Efforts to Stimulate the Economy

11. Tokyo's efforts to stimulate the economy were focused on monetary policy until recently. From 28 October 1970 to 28 July 1971 the Bank of Japan cut the discount rate in four steps from 6.25% to 5.25%, a postwar low. These moves had little effect, however, because by the time the government acted, the problem was no longer a shortage of funds but overcapacity and reduced investor confidence.

12. By mid-summer 1971, Tokyo decided to pursue an expansionary fiscal policy. The Diet passed the government's supplementary budget bill in early November. Unlike the legislation adopted during the 1965 recession, which simply allowed borrowing to offset lower-than-expected revenues, this bill calls for increased expenditures and reduced income taxes. Much of the increased spending is earmarked for education, public welfare facilities, highways, drainage systems, and housing. The bill will nearly double the planned government deficit in fiscal year (FY) 1971 (ending 31 March 1972). This deficit is to be financed by selling $2.5 billion worth of national bonds.

13. In early December the government was planning to offset the deflationary impact of an assumed 15% revaluation of the yen by increasing current and capital outlays in FY 1972 by 18% and 30% respectively, compared with FY 1971. Moreover, Tokyo announced its intention to consult with the Bank of Japan concerning another cut in the discount rate to as low as 4.75%. Although the yen has now been

revalued in dollar terms by nearly 17%, Tokyo thus far has indicated it does not intend to change its budget plans.

Short-Term Prospects

14. Most Japanese forecasters have been predicting that the economy will continue in the doldrums through the first quarter of 1972 and rebound thereafter. For example, the respected Japanese Economic Research Center (JERC) recently predicted annual rates of real GNP growth of 2.7% in the first quarter and 5.7%, 7.7%, and 13.2% in the remaining three quarters, for an overall 1972 gain of 7.4%. Since the JERC assumed only a 14.3% revaluation in terms of the dollar, it probably would project a somewhat slower recovery now. The actual revaluation of nearly 17% in terms of the dollar and 11% overall should slow the growth of exports and affect the growth of GNP by more than the JERC estimated.

15. Many Japanese economists believe that economic growth will accelerate mainly because of rapidly increasing housing investment and government capital outlays. According to the JERC, expansion in housing investment will rise from the 1971 rate of 12% to a little more than the 21% rate of 1966-70. The greatest spur, however, is expected to come from government capital outlays. These expenditures are projected to grow 32% in 1972, compared with the 15% average of 1966-70. Inventory rebuilding is also slated to boost investment, but spending on new plant and equipment will grow very little because of overcapacity. Both consumer and government consumption are forecast to continue their steady upward pace.

16. All of the JERC's estimates, except that for government investment, lie within what we consider to be a reasonable range,* although several are near the range's extreme (see the table). The JERC's estimated 7.4% rise in real GNP, for example, seems optimistic -- although possible. We judge

* *The JERC employs an econometic model, while our estimates are extrapolations of past trends, adjusted to take into consideration the present economic situation and the economy's behavior during past recovery cycles.*

that real GNP will increase between 5% and 8% in 1972, with 6-1/2% being the best estimate.

17. Even though the government is intent on increasing public investment and opportunities abound, it probably cannot boost such outlays by anything near the 32% foreseen by the JERC. There is a considerable leadtime between the planning and actual construction phase of road, railroad, housing, and school projects. Indeed, the government will have difficulty getting large infrastructure projects under way because the construction industry is already working near full capacity and housing construction is expected to rise.

18. Whatever its economic growth rate during 1972, Japan is likely to maintain a highly favorable balance-of-payments position. The Japanese will have a trade surplus of some $6 billion even if imports grow by 25% in dollar terms (compared with 7% in 1971) and exports by only 10% (compared with 25% in 1971). With such a trade surplus, the Japanese could be expected to have a current account surplus of more than $4 billion and a basic balance of at least $2.0 billion. A substantial net outflow of short-term capital is likely as the $5 billion or more borrowed abroad during 1971, mainly as a hedge against the yen's revaluation, is repaid. But with Japanese foreign exchange reserves now amounting to $15 billion, this outflow will not present any difficulty for Tokyo.

Estimated Japanese Growth Rates in 1972

Percent

	JERC	CIA
Private consumption	13.5	12.5 to 14.0
Government consumption	15.2	13.0 to 17.0
Fixed investment		
Private housing	22.5	12.5 to 22.7
Plant and equipment	1.9	-2.0 to 5.0
Government	32.1	15.0 to 25.0
Inventory investment	16.6	16.6 to 10.0
Exports a/	0.3	0.3 to 6.8
Imports a/	7.5	5.0 to 10.0
Nominal GNP	12.8	9.3 to 13.6
Inflation	5.4	4.5 to 5.5
Real GNP	7.4	4.8 to 8.1

a. Because of yen revaluation, the rates of growth of imports and exports calculated in yen for purposes of estimating GNP do not correspond to the rates of growth of exports and imports calculated in dollars for purposes of the balance of payments. For information on Japan's balance of payments outlook, see paragraph 18.